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Internal control: elements of a coordinated system and its importance to management and the independent public accountant, special report

American Institute of Certified Public Accountants. Committee on Auditing Procedure

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INTERNAL CONTROL

**ELEMENTS OF A COORDINATED SYSTEM AND ITS IMPORTANCE
TO MANAGEMENT AND THE INDEPENDENT PUBLIC ACCOUNTANT**



**SPECIAL REPORT BY THE
COMMITTEE ON AUDITING PROCEDURE**



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INTERNAL CONTROL

One of the most important developments in public accountancy during recent years has been the constantly growing understanding by both management and the public accountant of the complementary nature of their respective responsibilities and of their interdependence upon each other in discharging those responsibilities. This, together with the common desire for efficiency and for dependable accounting results, has fostered a high degree of collaboration between them to the advantage of both. In earlier periods the independent accountant frequently had to examine practically all transactions and make dozens of journal entries before reasonably accurate financial statements could be prepared. Under current conditions, in most engagements undertaken for the purpose of expressing his independent expert opinion upon the fairness of management's representations, the public accountant expects the company's accounting department to produce financial statements and collateral accounting records which management is satisfied are proper, complete and free of material error.

This analytical study, directed particularly to the consideration of the nature and characteristics of internal control and to the delineation of the respective spheres of interest and responsibility of management and the public accountant, was undertaken with the belief that the opportunities to achieve additional mutual benefits may be realized more fully by applying the same kind of collaboration further to the common problem of internal control.

INCREASING SIGNIFICANCE OF INTERNAL CONTROL

The constantly expanding recognition of the significance of internal control may be attributed to the following factors:

The scope and size of the business entity has increased to the point where its structural organization has become complex and widespread. To control operations effectively, management must depend on the reliability of numerous reports and analyses.

The primary responsibility for safeguarding the assets of concerns and preventing and detecting errors and fraud rests on management. Maintenance of an adequate system of internal control is indispensable to a proper discharge of that responsibility.

The protection which a properly functioning system of internal control affords against human weaknesses is of paramount importance. The check and review which is inherent in a good system of internal control reduces the possibility that errors or fraudulent attempts will remain undetected for any prolonged period and enables management to place greater confidence in the reliability of data.

It is impracticable for public accountants to make detailed audits of most companies within economic fee limitations. Furthermore, a subsequent examination cannot be regarded as a substitute for the exercise of proper controls in the actual handling of transactions.

ELEMENTS OF A PROPERLY COORDINATED SYSTEM

Internal control comprises the plan of organization and all of the coordinate methods and measures adopted within a business to safeguard its assets, check the accuracy and reliability of its accounting data, promote operational efficiency, and encourage adherence to prescribed managerial policies. This definition possibly is broader than the meaning sometimes attributed to the term. It recognizes that a "system" of internal control extends beyond those matters which relate directly to the functions of the accounting and financial departments. Such a system might include budgetary control, standard costs, periodic operating reports, statistical analyses and the dissemination thereof, a training program designed to aid personnel in meeting their responsibilities, and an internal audit staff to provide additional assurance to management as to the adequacy of its outlined procedures and the extent to which they are being effectively carried out. It properly comprehends activities in other fields as, for example, time and motion studies which are of an engineering nature, and use of quality controls through a system of inspection which fundamentally is a production function.

What may be said to be the characteristics of a satisfactory system of internal control? Certainly, they would include:

- A plan of organization which provides appropriate segregation of functional responsibilities,

- A system of authorization and record procedures adequate to provide reasonable accounting control over assets, liabilities, revenues and expenses,

- Sound practices to be followed in performance of duties and functions of each of the organizational departments, and

- A degree of quality of personnel commensurate with responsibilities.

These elements, as important as each is in its own right, are all so basic to proper internal control that serious deficiencies in any one normally would preclude successful operation of the system. For example, no plan of authorization and record procedures for accounting control may be considered adequate without personnel capable of performing the procedures designed to make such a system work, nor can one consider the practices followed in the performance of duties in the organizational departments sound unless there is departmental independence so that responsibilities can be placed and interdepartmental controls enforced. In the following pages, each element is discussed separately, but to comprehend fully the significance of each, the reader must constantly bear in mind the interrelationship of all the elements.

Plan of Organization

The size and scope of the present-day enterprise is such that in most cases executive management can no longer exercise personal supervision over the conduct of operations. Under the circumstances the establishment of a suitable organizational structure is essential.

The appropriate organizational structure will vary with the type of enterprise, its size, the extent to which its operations are geographically separated, the number of operating subsidiaries, if any, and other factors which may be peculiar to the particular enterprise. It is not our purpose here to discuss various types of organizational structure and the advantages or disadvantages of each. Generally, a satisfactory plan should be simple, to the extent that such simplicity is advantageous from an economy point of view; it should be flexible so that expansion or changing conditions would not materially disrupt or disorganize the existing arrangement; and it must lend itself to the establishment of clear lines of authority and responsibility. Our concern here is mainly with the last objective.

Organizational Independence of Departments

An important criterion as to the adequacy of any plan of organization is the extent to which it provides for organizational independence as between operating, custodian, and accounting (including internal auditing) departments. Organizational independence does not imply the erection of any barriers preventing frequent consultation between departments to devise means of smoothing the flow of work and increasing the over-all efficiency of operation. The work

of all departments must be closely integrated and coordinated and, to that end, cooperation is essential. The basis for the separation rests on the premise that no department should control the accounting records relating to its own operations. It represents an extension at the departmental level of the oft-repeated principle that no one person should control all phases of a transaction without the intervention of some other person or persons who afford a cross-check. Without such a separation, the accounting records may be so manipulated as to make the detection of errors and fraud extremely difficult, if not impossible.

Misrepresentations may arise where rewards for good performance are in the offing, particularly if such performance is being measured in part by adherence to set standards or budgets. For example, if the production department recorded its own costs and certain operations were running over the prescribed standards, the production head could decide on his own initiative to allocate a portion of the cost to an operation running below the standard. The same type of misrepresentation could likewise be readily made by reallocating budgeted expenses. By such action, it may appear from the reports of operation that an excellent job is being done and management, by relying on the data under such circumstances, may be misled. Prompt revelation of the variances might properly have called for changes in both the production and sales policies of the company. An accounting department, independent of operations and with no direct interest in production other than the accurate recording of the cost data with its attendant checks on authorizations and adherence to controls, can present to management such reports and analyses as are required for control of operations. The planned organizational independence among departments thus serves to establish the reliability and integrity of the information.

The desirability of the separation of operation and accounting applies equally to the custodian departments. For example, the material department should not have access to the records by which the integrity of the storekeeping is determined. Likewise, where possible, the handling of the receipt and disbursement of funds should be divorced from the accounting function. It follows that the accounting department should not have operational or custodianship functions.

An internal audit staff may be used not only as a check on the accuracy of the accounting data and the safeguarding of the company's assets, but also as an instrument of management in determin-

ing adherence to prescribed policies. Thus, the audit activities should be widespread, covering all departments. The review and appraisal to be useful to management must be unbiased—free from any departmental influence as to the scope of the audit program and the method of reporting thereon. The internal auditor should be free to advise management of any deficiencies noted, without fear of reprisal from any department heads. His relationship to the department head should be clearly set forth by management to avoid any misunderstanding as to their relative positions. Under such conditions the internal auditor is in a position, without any limitations, to serve management in the detection of frauds, weaknesses in procedures and in the clarification of policies on a company-wide basis.

In many instances, while the size of the organization may warrant segregation of the internal audit function, the economic employment of personnel of the quality compatible with complete independence may not be practicable. Under such conditions the question often arises as to the propriety of incorporating the internal audit function into the sphere of the controller. An arrangement of this sort is generally regarded as satisfactory, assuming independence of the accounting and auditing function at the next lower level. Such an arrangement has, in fact, been adopted in the plan of organization used as an illustration in the appendix to this discussion.

Lines of Responsibility

Assuming a proper functional division of the activities of an enterprise, the next step is to establish responsibility within the divisions for their efficient operation in conformity with the prescribed requirements as laid down by top managerial policies. With the placement of responsibility must go the delegation of authority whereby such responsibilities may be met. Responsibilities and the attendant delegation of authority should be clearly defined and wherever possible set forth in either an organizational chart or manual, available to all parties affected. Conflicting and dual responsibilities should be avoided wherever possible, but where the work of two or more divisions is complementary, as is very often the case, the responsibility for the various phases may be divided, and properly so. Such a division is inherent in good internal control, which provides that the functions of initiation and authorization of a transaction, the recording, and the custody of the resultant asset be separated.

For example, the materials department is responsible for the maintenance of inventories at a certain level, and when an item falls below that level, a request for purchase will be initiated. The responsibility for the next phase of the transaction moves on to the purchasing department which must act on the request. An order must be placed with a vendor, in accordance with specifications given, to be delivered at the designated time of need, and at a satisfactory price. The responsibility for the receipt of the merchandise, its examination as to quantity and quality and comparison with the purchase order, notation of defects or shortages, and the transmission to stores rests with the receiving department. The setting up of the liability, recording of the transaction, and approval for payment of the vendor's invoice based on the documentary support received from the other departments is an accounting department function.

The chain of responsibility does not stop with the departmental heads. Within a particular department it should move downward, but always in a *continuous* line. For example, an accounts payable clerk may be responsible to the chief accountant for the preparing of vouchers for final approval and subsequent payment. Responsible to him may be another clerk whose job is to match invoices, purchase orders and receiving reports. Responsibilities may take the form of strict custodianship accountability, such as a stores clerk in a warehouse, or the petty cashier as custodian of the petty cash funds.

In many enterprises there are departments or individuals whose functions do not relate directly to the conduct of operations, whose main purposes may be to review, advise, analyze or summarize and report thereon. Where such departments exist, it is extremely important that their responsibilities not only be stated clearly but that all divisional heads be cognizant of those responsibilities and the extent to which they relate to the operations within their own departments.

System of Authorization and Record Procedures

Accounting and Procedures Manuals Desirable

Once management has determined its objectives, has provided an appropriate plan of organization, and has delegated the responsibility for the attainment of the objectives, it must have media, first, for the records control of the ensuing operations and transactions and, **second**, for the classification of data within a formal structure of accounts. The latter medium is commonly referred to as a chart of

accounts. A carefully prepared chart of accounts serves a far more useful purpose than the mere provision for slots into which transactions are to be dropped. The accounts selected and their sequence should, at a minimum, meet the following tests:

- (1) Facilitate the economical preparation of financial statements and reports.
- (2) Include those accounts which are needed to reflect adequately and accurately the assets and liabilities and the revenues, costs and expenses sufficiently broken down to be useful to management in its control of operations.
- (3) Describe accurately and concisely what should be contained in each account.
- (4) Delineate as clearly as possible the boundary lines between capital assets, inventories, and expense items.
- (5) Provide for controlling accounts where necessary.

In connection with (3) it ordinarily is desirable to have in *widespread* use an account manual with explanations as to what should or should not be included in particular accounts. Clear account titles and an adequate numbering system will go a long way in the avoidance of classification and distribution errors.

Media for the original records control of operations and transactions are created through the designing of appropriate records and forms and through planning the logical flow of the record-keeping and approval procedures among departments and departmental sections. Such forms, and the instructions regarding the flow of recording and approval procedures, are often incorporated in "procedure manuals." A great deal of progress has been made in recent years in improved design and planning of record procedures, particularly from the viewpoint of utilizing modern mechanization devices. Many of the larger enterprises have recognized the importance of continuous attention to these matters and have organized methods and procedures divisions in their accounting departments.

Characteristics of Appropriate Records and Forms

A complete discussion of all the forms and records required by the varying types of businesses is infeasible since the needs of no two businesses will be exactly alike. However, we may note some of the principles to be applied in the adoption of a particular form or record.

It must serve a useful function in its relation to the procedures

designed to accomplish the objectives of management. For example, sales are a primary objective of management and the sales procedures will invariably call for the use of an approved sales invoice which serves a number of purposes, some of which are: (a) basis for an entry in the books of accounts; (b) authority for the shipment of merchandise; (c) the original document from which all summaries and analyses regarding sales are compiled, such as sales by areas, by product, and by salesmen, and total revenues from sales; and (d) the original document in support of salesmen's commissions.

It must be sufficiently simple so that it may be clearly understood by those who are to use it, enabling them to record data promptly, accurately, and at a minimum of cost.

It should be designed in the light of all its possible uses so that the number of different forms may be held to a practicable minimum.

It should be so constructed that proper handling would necessitate adherence to the control procedures set up, thereby providing a degree of internal check within the form or record. In the case of forms, blanks for authorizations and approvals relating to the various steps of the transactions, the alignment of the data to facilitate arithmetical check, and proper routing instructions are all examples of control which may be provided by proper designing.

Collateral Control Procedures

Procedures of many companies have been extended to include, where desirable and economically feasible, material and production controls, appropriate cost systems, budgetary controls, the provision for periodic summaries and reports, and in the case of larger companies the use of an internal audit staff. Instructions as to the enactment of all procedures should be included in a procedures manual. The instructions to be used advantageously should be clear and complete but sufficiently concise to avoid being so voluminous as to be cumbersome. Oral instructions should be avoided wherever possible. They are frequently misunderstood and often occasion ill feeling among supervisors and other personnel.

Sound Practices

If the development of a plan of organization and the design of the flow of procedures be likened to a strategical plan, the adoption of sound practices may be called the tactical measures for the effectuation of the plan. The soundness of the practices followed in the performance of the duties and functions of each of the organizational

departments will largely determine the effectiveness of the internal control and the resultant efficiency in operations.

Control Through Division of Duties

The procedures adopted should provide the steps whereby transactions are authorized, recorded and the custody of assets accounted for. Sound practices should provide the means whereby the integrity of such authorizations, recordings and custody may be reasonably assured. This is usually accomplished by a division of duties and responsibilities so that no one person will handle a transaction completely from beginning to end. The person authorizing or initiating the transaction should have no part in either its recording or the stewardship of the asset. Where circumstances will not permit such a division, other protective practices must be found. By such a division, an automatic check on the accuracy of the work is provided and the probability of errors or fraud being detected promptly is substantially enhanced. As was mentioned earlier, this division of responsibility applies departmentally as well as to individuals, and should carry through the entire organization at all levels of authority.

Other Sound Practices

It is not our object in this discussion to enumerate all the practices in the various departments which, under a certain set of circumstances, would be sound. However, a few illustrations will serve to clarify the meaning of sound practices and to distinguish them from authorization and record procedures.

In the case of pay rolls, procedures would supply the various forms, such as employment and rate authorization, employee clock cards, job or hourly time tickets, pay roll and pay check or envelope. They would also provide for orderly routing and handling of the related records in the various departments. Practices adopted in carrying out the procedures would be largely determinative as to whether satisfactory internal control exists. Thus, punching clock cards becomes effective internal control only through observance by time-keepers to determine that properly authorized cards are punched by the employees to whom they were issued. Sound practices would also require (1) the checking of job time tickets to the clock cards, (2) the independent balancing of total labor charges originating from the cost department job tickets with the pay roll prepared by the pay roll department from the employees' clock cards, (3) distribution of pay checks or envelopes, frequently if not continuously,

by persons in no way engaged in the preparation of the pay roll, and (4) independent control of checks or envelopes not called for.

Other examples of sound practices in other areas would include: listing of approved suppliers, competitive quotations of prices on purchases, independent count of merchandise received, verification of invoices and supporting documents by accounting department as basis for payment, use of enclosed warehouses, bonding of employees, etc.

Integration of the System

An important feature of an adequate system of control is the molding of its integral parts into a smoothly functioning unit. The installation of the system, adequate as it may appear to be, provides no assurance that it will function efficiently on its own momentum. Interdepartmental cooperation is based to a considerable degree on human relationships, and two persons, however competent in their own right, may not always be compatible. Thus, management must always keep its fingers on the organization's pulse to detect any tremors arising out of conflicts between departments which might arise, for example, from varying interpretations of authority or reluctance to yield authority as a matter of personal pride. Periodic conferences by management will provide a possible means not only of detecting such differences but also of rectifying them.

Adequacy of Personnel

A properly functioning system of internal control depends not only on effective organization planning and the adequacy of the procedures and practices, but also on the selection of officers and department heads of ability and experience and operating personnel capable of carrying out prescribed procedures in an efficient and economical manner. To use an experienced accountant as an accounts payable clerk might insure efficiency but it would not be economically feasible or desirable since the talents of such an individual could be more advantageously utilized in a position of greater responsibility; conversely, to place an inexperienced clerk in a responsible position requiring judgment would be injudicious. The problem resolves itself mainly into the recognition by management of the need for careful analysis of a position and the qualifications required of the person to fill it, an adequate employee training program, and adoption of means whereby the quality of the employee's performance may be measured.

Employment Practices

Recognition of the importance of the initial selection of employees in avoiding rapid turnover, with its resultant waste, has manifested itself in the more general use of a specialized personnel department. Acting on approved departmental requests, the personnel department, utilizing a variety of appraisal devices to judge personality, ability, etc., selects those applicants who it feels best measure up to the requirements for the position. It is considered best practice to have the departmental head requesting the employee make the final choice from among the chosen applicants. Such practice obviates the possible contention by the department head, as an excuse for poor performance, that the employees were thrust upon him by the personnel department.

Sound employment practices require thorough investigation of the character of all applicants. The factor of "relative risk" obviously must be considered and the degree of investigation should be greatest in those cases where employees are being considered for positions where, by reason of the nature of the work to be done or the responsibility which attaches to the position, opportunities for perpetrating frauds are the greatest. The need for fidelity bond coverage of all such employees or positions is so well recognized that it need not be discussed here at length. One of the collateral advantages which results from a sound policy of fidelity bond coverage is the fact that underwriters almost invariably investigate the past records of employees to be bonded. These investigations on occasion will develop information which has not been disclosed by inquiries of the personnel department.

Employee Training

A critical area relative to effectiveness of the internal control is that which covers the training of the employee in the application of the procedures, and a difficult phase of this indoctrination process is to impress the employee with the necessity of *strict adherence* to outlined procedures and controls. The disciplining must be accomplished without destroying or retarding the individual's capacity to think and reason. When a task becomes a matter of mechanical routine, initiative is stifled, occasioning laxities, with a resulting decrease in effectiveness.

The program of employee training differs between companies. Some of the larger companies have training courses which the em-

ployee must complete prior to performing at the position he is to occupy. Other programs run concurrently, with the employee working by day and receiving instruction in the evenings. Such carefully planned and systematic approaches for the selection and training of personnel are desirable wherever economically justified. This is particularly so in that they generally cover not only procedures and controls that relate to the individual's particular work but also instruction relating to the entire cycle of operations, and the procedures and controls relating thereto. Such training broadens the individual's perspective, cultivates a greater interest in his work, and impresses on him through actual illustration, the need for organizational discipline.

In many companies, employee training will fall under the department heads who may either supervise the training personally, or as is usually the case, delegate the responsibility to the various section supervisors. Instruction at this stage would be required regardless of preliminary training, but to a varying degree depending on the extent of the preliminary training. Where training by supervisors represents the only medium of instruction, the pressure of the normal daily work may cause such instruction to be neglected. When such pressure exists, it is a common failing on the part of the supervisors to omit the "why" of a procedure or control. An employee who is told to follow certain procedures, without being told the reason, may decide on his own initiative to circumvent certain procedures which *to him* seem unnecessary.

Checking on Performance

Adequate instruction, however, will not in itself insure good performance. The work of the employee must be carefully reviewed to determine that procedures are being followed and, if not, the causes must be promptly determined and corrective measures taken. This review should apply to all levels of responsibility, and may be conducted by a variety of methods:

By other employees, where the work of two or more employees is complementary and the work of one provides a check on the accuracy of the other.

Review on the part of the supervisors or department heads of the operation of their subordinates.

A well devised system of reports to management, which, when properly prepared and analyzed, would indicate weaknesses in the chain of responsibility.

Utilization of special control devices such as standard costs, a system of budgetary controls, or an internal audit staff, and, at the production level, time and motion studies and quality standards.

INTERNAL CONTROL AND MANAGEMENT

Management has the responsibility for devising, installing and currently supervising a system of internal control adequate to: (1) safeguard the assets of an organization; (2) check the accuracy and reliability of accounting data; (3) promote operational efficiency; and (4) encourage adherence to prescribed managerial policies; and, for these purposes, to provide an appropriate plan of organization; an adequate system of authorization and record procedures; sound practices and, lastly, personnel of appropriate number and capabilities. Decisions reached as to the first three of these elements of internal control lend themselves to orderly and effective recording. The broad design, considerations of detail, and the integration of the whole system of internal control, demand careful planning. It is the view of this committee that such planning may be best accomplished by "laying out" the plan of internal control on paper in much the same manner as physical construction projects are conceived, designed and tested architecturally before they are approved.

Effective internal control is so pertinent to the question of the reliability of financial data and so fundamental to a proper discharge of management's total responsibility as to require that management be prepared to demonstrate the steps taken to attain it. A chart of accounts testifies to the adequacy of a plan of accounts, and a properly prepared procedures manual provides a standard with which the actual procedures in use may be compared to detect departures which may afford opportunities for irregularities whether fraudulently conceived or otherwise. Detailed description in a procedures manual may be greatly simplified if management will develop and utilize a visual plan of organization and of the flow of transactions. Wholly apart from the day-to-day contribution which they make to good management, soundly conceived charts of accounts, well written and complete manuals of accounting policies and procedures, and organization and flow charts obviously greatly facilitate the public accountant's review of internal control and, by their orderliness, contribute materially to a higher quality of review.

It is impossible to devise any one system of internal control which will provide all the safeguards, and meet the requirements of every

company, irrespective of size and type. Each company has its own peculiar problems, and measures adequate in one instance will not suffice in another. Controls, likewise, must be considered in the light of their economic utility. In instances where the cost of protection would far outweigh the possible losses, or where certain controls may retard operations to the point of adversely affecting production or sales, management may decide that such controls are not feasible.

The responsibility of management does not end with the installation of control procedures initially deemed necessary. A system of internal control must be under constant surveillance to determine (1) that prescribed policies are being interpreted properly and are being carried out, (2) that changes in operating conditions have not made the procedures cumbersome, obsolete or inadequate, and (3) that where breakdowns in the system appear, effective corrective measures are taken promptly. Any system, regardless of its fundamental soundness, will deteriorate rapidly if not reviewed periodically. Laxity becomes contagious and, if permitted to spread, will soon render any measures of control useless.

INTERNAL CONTROL AND THE PUBLIC ACCOUNTANT

While the primary responsibility for the establishment and enforcement of internal control measures rests with management, the degree to which such measures exist and are carried out is of great concern to the public accountant. The following excerpts, taken from Statement on Auditing Procedure No. 1 and repeated in a special report entitled "Auditing Standards" issued by the committee on auditing procedure of the American Institute of Accountants, give further emphasis to this point:

The independent auditor must also exercise his best judgment in determining the scope of his examination and in deciding whether the interests of stockholders and creditors justify the time and expense involved in the extension of any particular line of inquiry. . . . It is the duty of the independent auditor to review the system of internal check and accounting control so as to determine the extent to which he considers that he is entitled to rely upon it. To exhaust the possibility of exposure of all cases of dishonesty or fraud, the independent auditor would have to examine in detail all transactions. This would entail a prohibitive cost to the great majority of business enterprises—a cost which would pass all bounds of

reasonable expectation of benefit or safeguard therefrom, and place an undue burden on industry. . . .

It is worthy of repetition that the extent of sampling and testing should be based upon the independent auditor's judgment as to the effectiveness of internal control, arrived at as a result of investigation, tests and inquiries. Depending on his conclusions in this respect, the independent certified public accountant should extend or may restrict the degree of detailed examination.

Reliance Upon Plan of Organization

To the public accountant organizational independence among departments, by its very existence, provides a condition conducive to good internal control. His reliance on such a division of functions will depend, however, on the degree to which the departments are, in fact, independent in their performance. Observance of operations, review of reports, and tests, wherein the operation of a number of departments may be involved, provide the means whereby the public accountant may determine the validity of the division of responsibilities. Where the tests indicate that the separation of functions exists and is operating as an effective check on performance, the independent public accountant will adjust his audit program accordingly.

An internal audit staff is a strong factor in a system of internal control, and the public accountant, in addition to appraising its status, should survey its activities to determine their effect on his selection of appropriate audit procedures and the required extent of tests. The work of the internal auditor should be considered by the public accountant as a supplement rather than as a substitute. For example, the independent auditor may select a certain number of plants at which to test inventories. Arrangements might well be made to have the internal auditors verify those not selected by the public accountant. Opportunities for such cooperation are becoming more common with the growing recognition by industry of the importance of the internal audit function.

Reliance Upon System of Authorization and Record Procedures, and Sound Practices

The adequacy of the system of authorization and record procedures and the degree to which it is functioning as planned are also of vital interest to the independent accountant in his selection of appropriate audit procedures. The public accountant should

familiarize himself with the authorization and record procedures, judge their adequacy and determine whether such procedures are actually being effectuated by sound practices in order to accomplish the purposes for which they were designed. Consultation with officers and employees, and general observation of routines will provide certain information but the most desirable method of conducting the review is by actual test of the system's operation. Such tests may take the form of analyses of certain accounts for a particular period, wherein the integrity and accuracy of the documents supporting the entries are appraised; the tracing of a series of transactions from their inception to final recording and accounting, with examination of supporting evidence at each stage; comparison of inventory records to actual physical counts; or confirmation of a selected group of accounts receivable.

Review of System of Internal Control

The public accountant's review of the system of internal control serves two purposes: first, it enables him to formulate an opinion as to the reliance he may place on the system to the end that, by adjusting his audit procedures accordingly, he may express an opinion as to the fairness of management's financial statements; and, secondly, where the review indicates apparent weaknesses, recommendations for possible corrective measures may be conveyed to management. This secondary aspect of his review frequently enables the public accountant to render broader services than those generally associated with his capacity as an independent reporter to stockholders upon management's conduct of stewardship responsibilities. His aid to management in attaining more efficient operation can and should be an equally important function. Determining the effectiveness of the organizational plan, division of responsibilities, and such special control procedures as budgetary controls, reports, analyses, and cost systems are among the areas which the public accountant should cover in his review. It is not anticipated that the independent auditor will be able to review all the control procedures within the course of any one audit. The review may very well be so arranged as to entail complete coverage over a period of several years. However, the review of those controls which relate directly to the accounting records should, if practicable, be conducted each year.

Where feasible, the accountant's review of internal control may be conducted as a separate phase of the examination, preferably at an interim date, by applying appropriate auditing procedures

directed particularly to appraising the effectiveness of the client's system. Where this is not feasible, the review will usually be done in conjunction with other phases of the audit program, such program to be subject to either limitation or expansion depending upon the degree of internal control present as evidenced by the tests made. On completion of the review, a documentary record in some suitable form should be prepared.

When the system of internal control is found to be unsatisfactory in some respects, the auditor should advise his client of such observed weaknesses in internal control so that the client may take what action he thinks is appropriate. Where the observed weaknesses in internal control have resulted in the extension of audit procedures beyond the scope which otherwise would have been necessary, the client should be advised that the correction of those weaknesses would make it possible for the auditor to reduce the scope of his work.

* * *

The committee wishes to make it clear that neither the preceding discussion of internal control nor the illustrative charts, which comprise the appendix, purport to set forth any formula or pattern by which the effectiveness of a particular system may be measured. The problem, of course, is much too complex for any such treatment. However, it is hoped that the presentation of the major elements of a properly coordinated system may lead to a better understanding of the nature and scope of internal control and to a fuller appreciation of the need for careful planning and continuous supervision by management.

The charts shown in the appendix are a case study presented for purposes of illustration. Obviously, the plan of organization and the procedures depicted will not be suitable to any wide number of organizations or circumstances. The procedures illustrated, however, are regarded as appropriate to and consistent with the organizational plan. Limitations of space naturally required considerable curtailment in the display of many aspects of internal control. This is particularly true in the areas of sound practices and internal auditing procedures. The principal advantages of the type of charts illustrated are believed to be, first, visual assistance in developing a coordinated plan of organization and procedures and, second, their use permits simplification in the descriptive material included in procedures and practice manuals.

In the various sections of this report references have been made

to the valuable aids afforded through functional organization charts, accounting classification manuals, procedures and practices manuals. Most companies have done some planning of internal control and have developed certain of the manuals and charts mentioned. Very few, however, have developed adequate plans and procedures to the point of being able to furnish the independent public accountant with comprehensive representations as to the plan and operation of internal control. While the committee believes that many companies will ultimately reach this "ideal" objective, it seems reasonable to expect that the process will follow an evolutionary course. In the meantime, the independent accountant will be required to spend considerable time and effort in the ascertainment of the pattern of internal control in existence, as well as in the testing and evaluation of the system as a basis for setting the scope of his examination.

Committee on Auditing Procedure

November, 1948.

Committee on Auditing Procedure (1947-1948)

Paul Grady, <i>Chairman</i>	Gordon M. Hill	Harold A. Mock
J. A. Boulay	A. Joel Jackson	Norman H. S. Vincent
Garrett T. Burns	Alvin R. Jennings	Karl R. Zimmermann
William D. Cranstoun	Thomas L. Keaney	
Ralph H. Galpin	C. Alvin Koch	
Henry I. Hamm	Malcolm Lamont	Carman G. Blough
Russell C. Harrington	Ira B. McGladrey	<i>Director of Research</i>

APPENDIX

A GRAPHIC ILLUSTRATION OF INTERNAL CONTROL

A correlated series of organizational and procedural flow charts showing the part played in achieving effective internal control by the segregation of functional responsibilities in a well planned organization, as adapted from a case study of a moderately-sized manufacturing company.

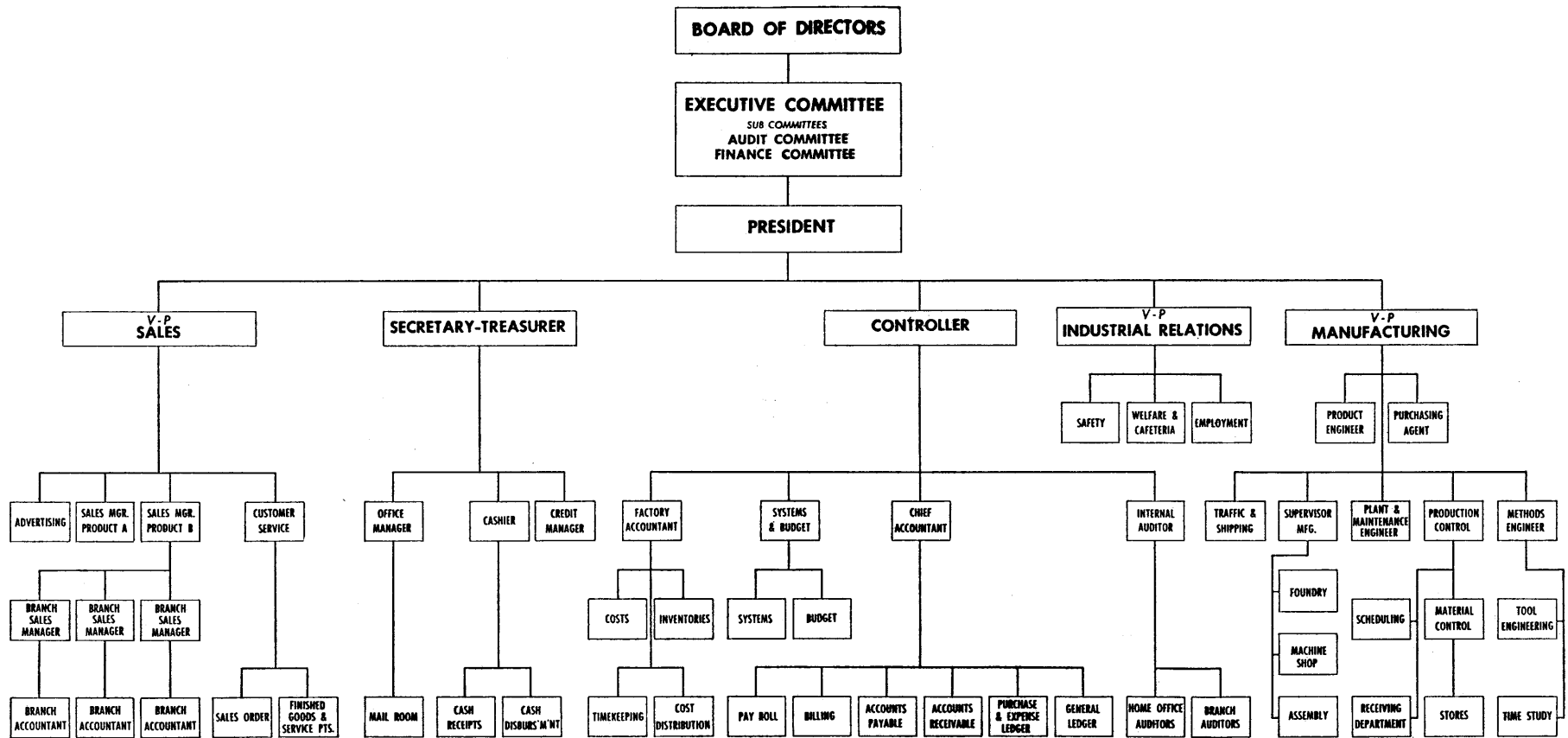
A GRAPHIC ILLUSTRATION OF
INTERNAL CONTROL

TABLE OF CONTENTS

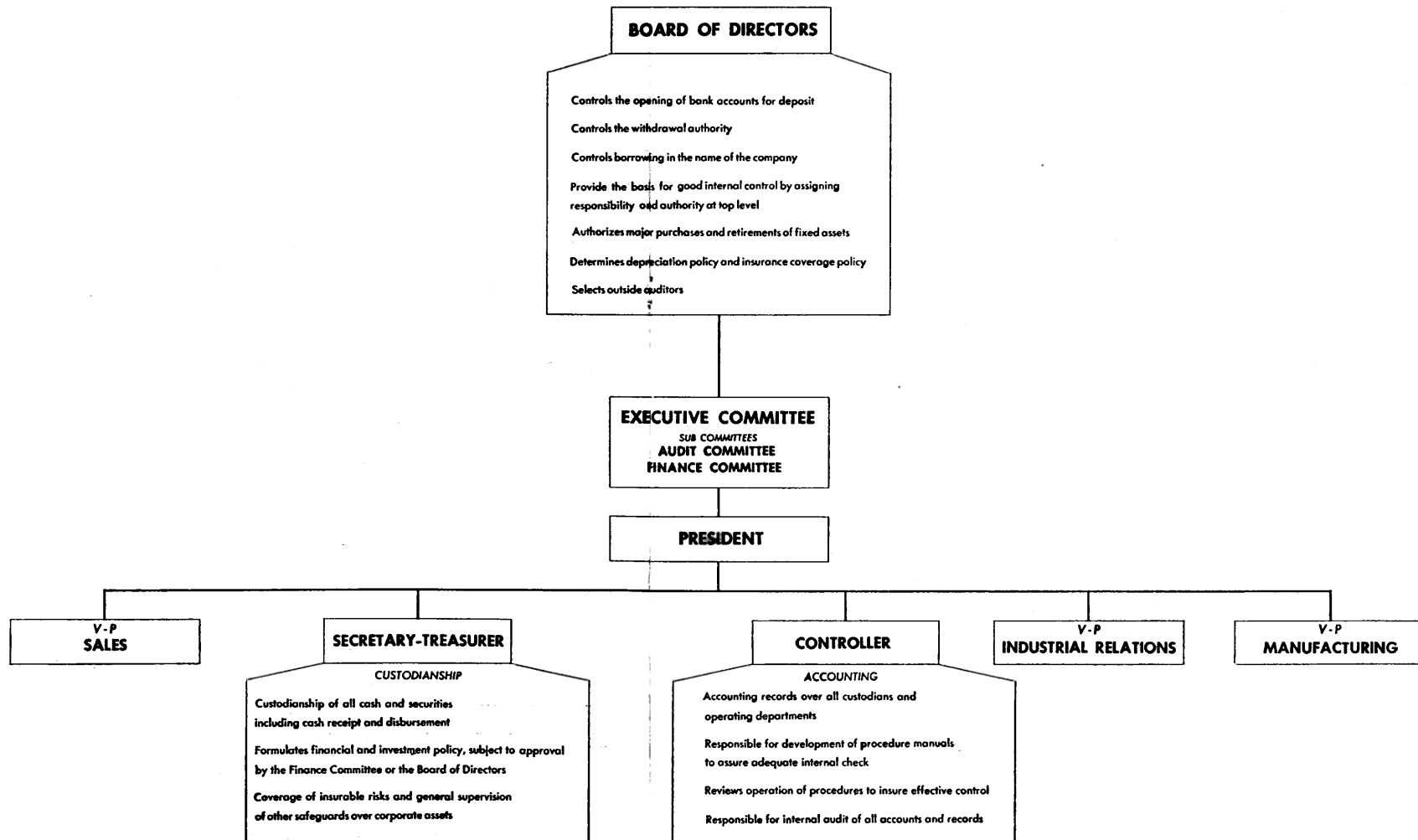
Organization charts showing the segregation of duties which provides the background for effective internal control:	Chart No.
Entire Organization	1
Top Supervisory Level	2
Controller's Division	3
All Other Divisions	4
Procedural flow charts shown in relation to organization chart to portray the control obtained through segregation of functional responsibility:	
Sales	5
Accounts Receivable	6
Cash Receipts	7
Purchases	8
Cash Disbursements	9
Pay Roll	10

ORGANIZATION CHART

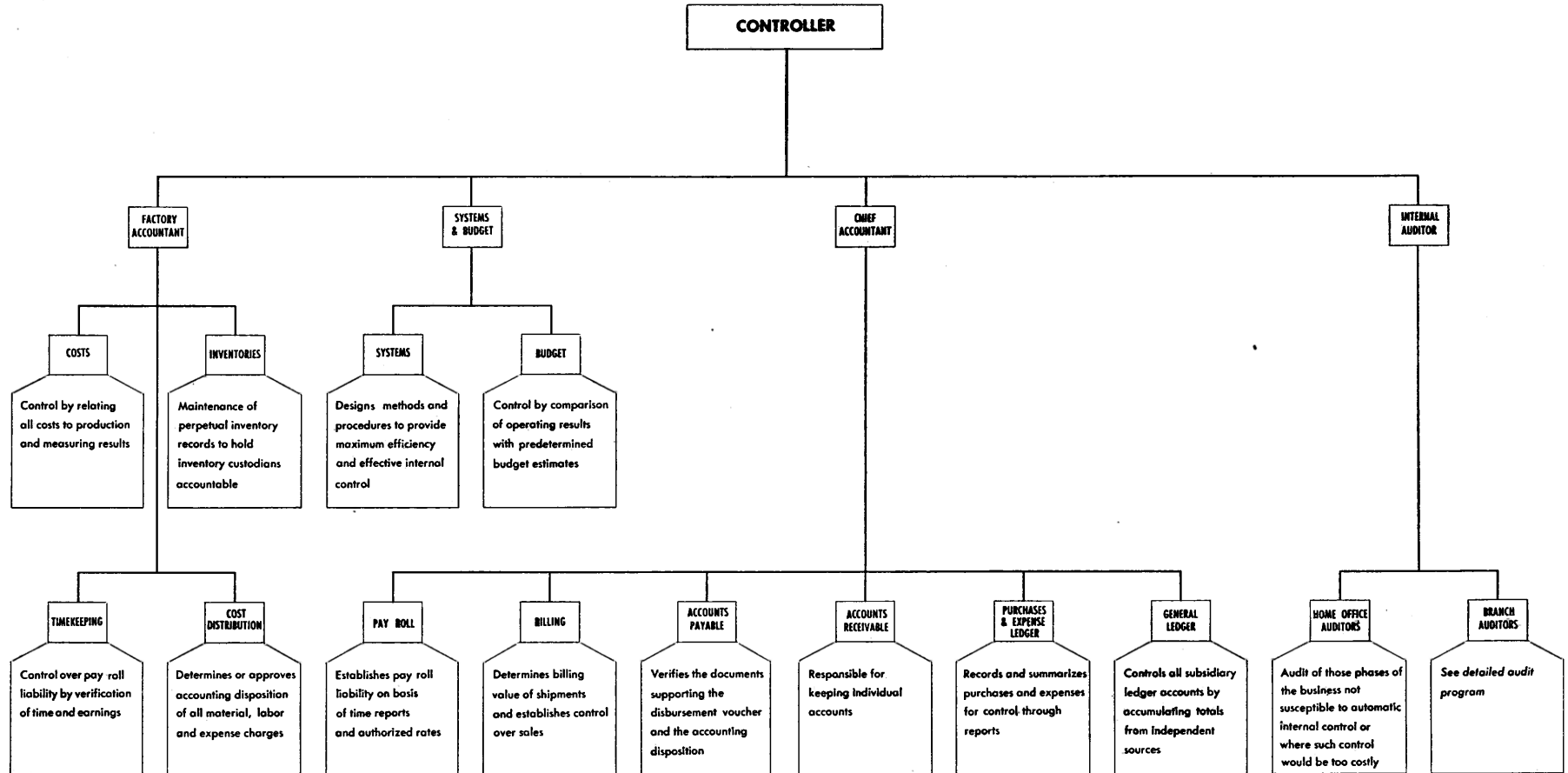
DEVELOPED FROM A CASE STUDY SHOWING
THE SEGREGATION OF FUNCTIONAL
RESPONSIBILITY USED AS A BASE
FOR INTERNAL CONTROL



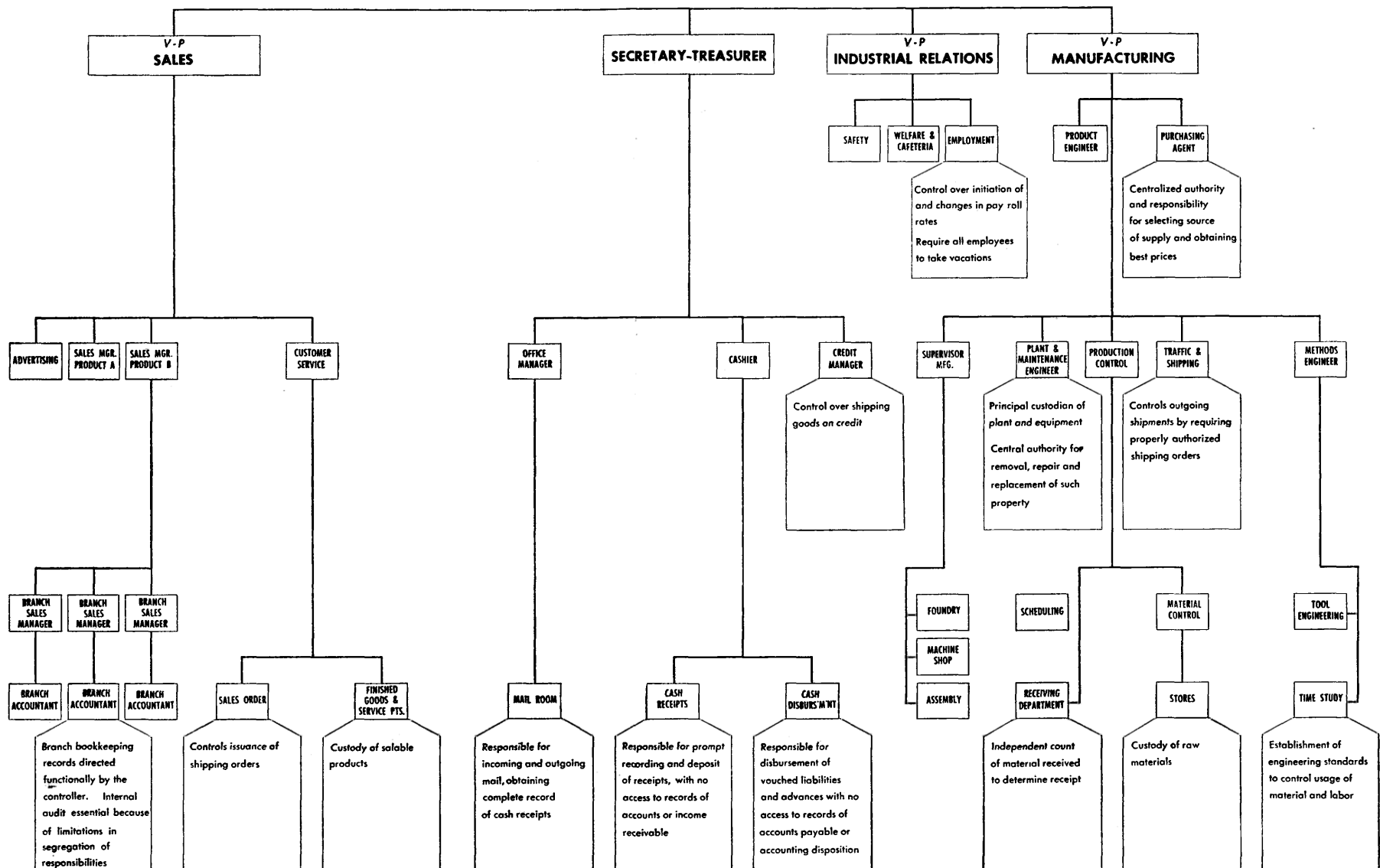
TOP SUPERVISORY LEVEL
ORGANIZATION CHART SHOWING
THE NECESSARY SEGREGATION OF DUTIES
REQUIRED TO OBTAIN
EFFECTIVE INTERNAL CONTROL



ORGANIZATION CHART **OF CONTROLLER'S DIVISION SHOWING FUNCTIONS** **INVOLVED IN INTERNAL CONTROL**

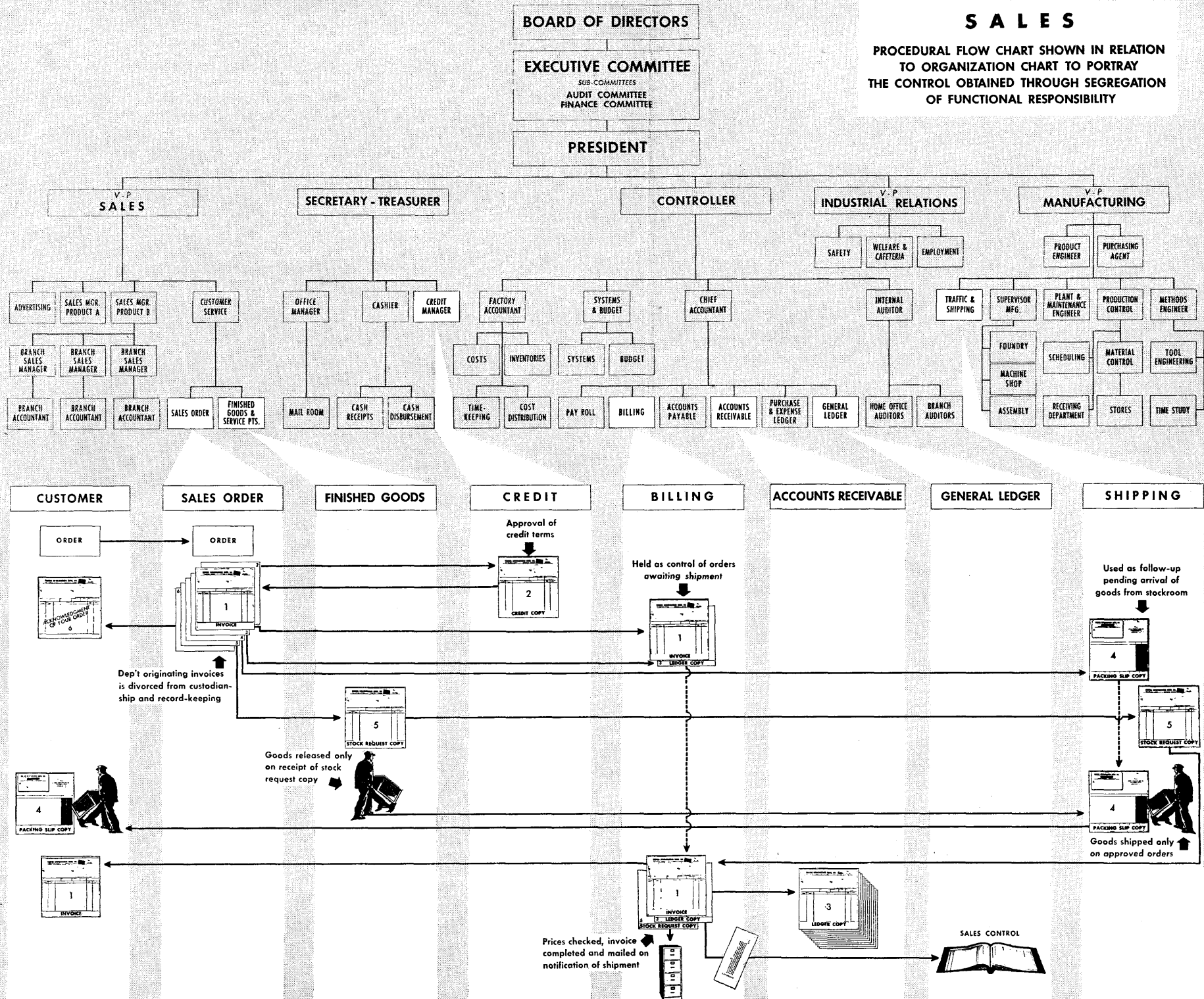


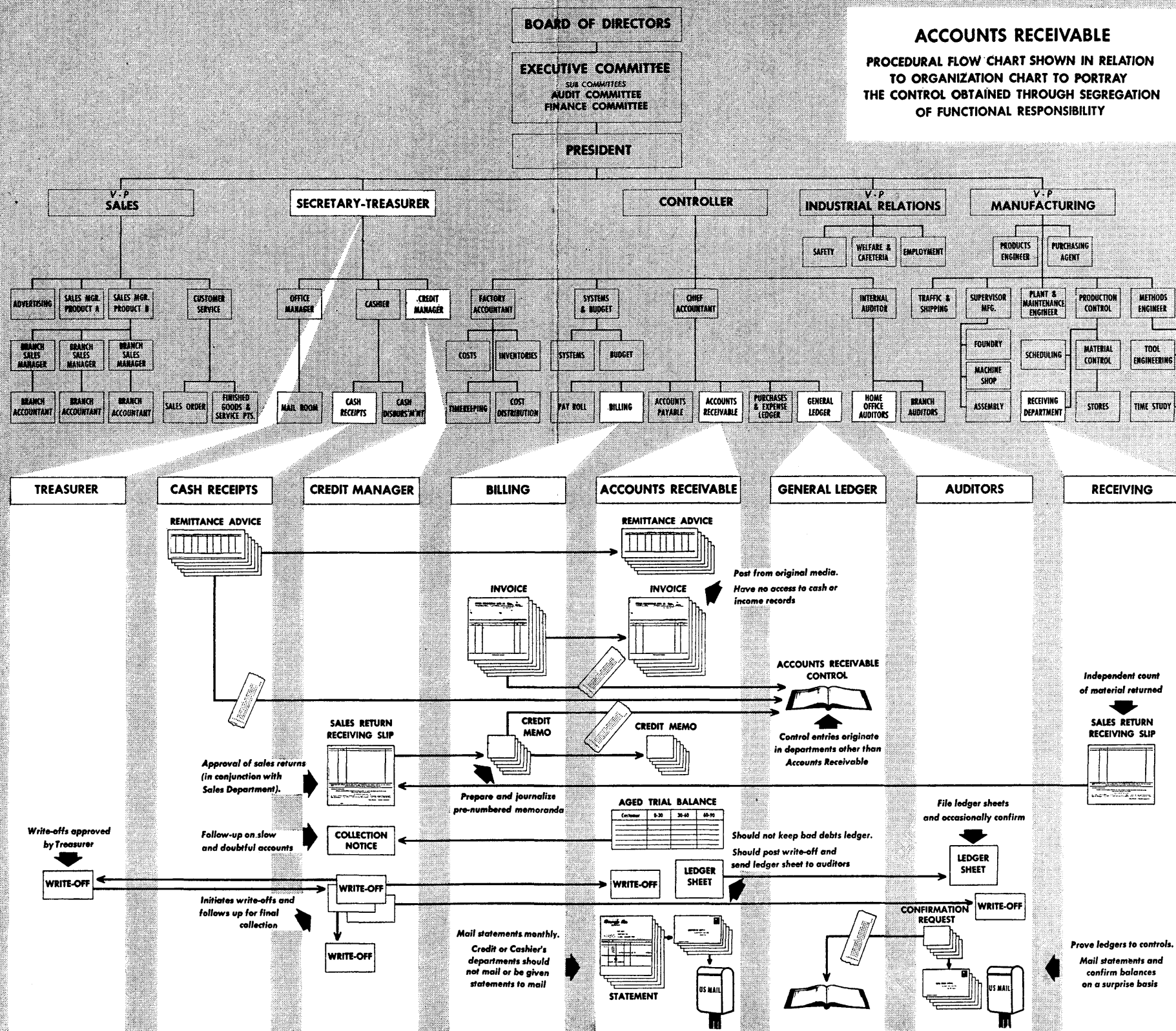
ORGANIZATION CHART
OF ALL OTHER DIVISIONS SHOWING FUNCTIONS
INVOLVED IN INTERNAL CONTROL



SALES

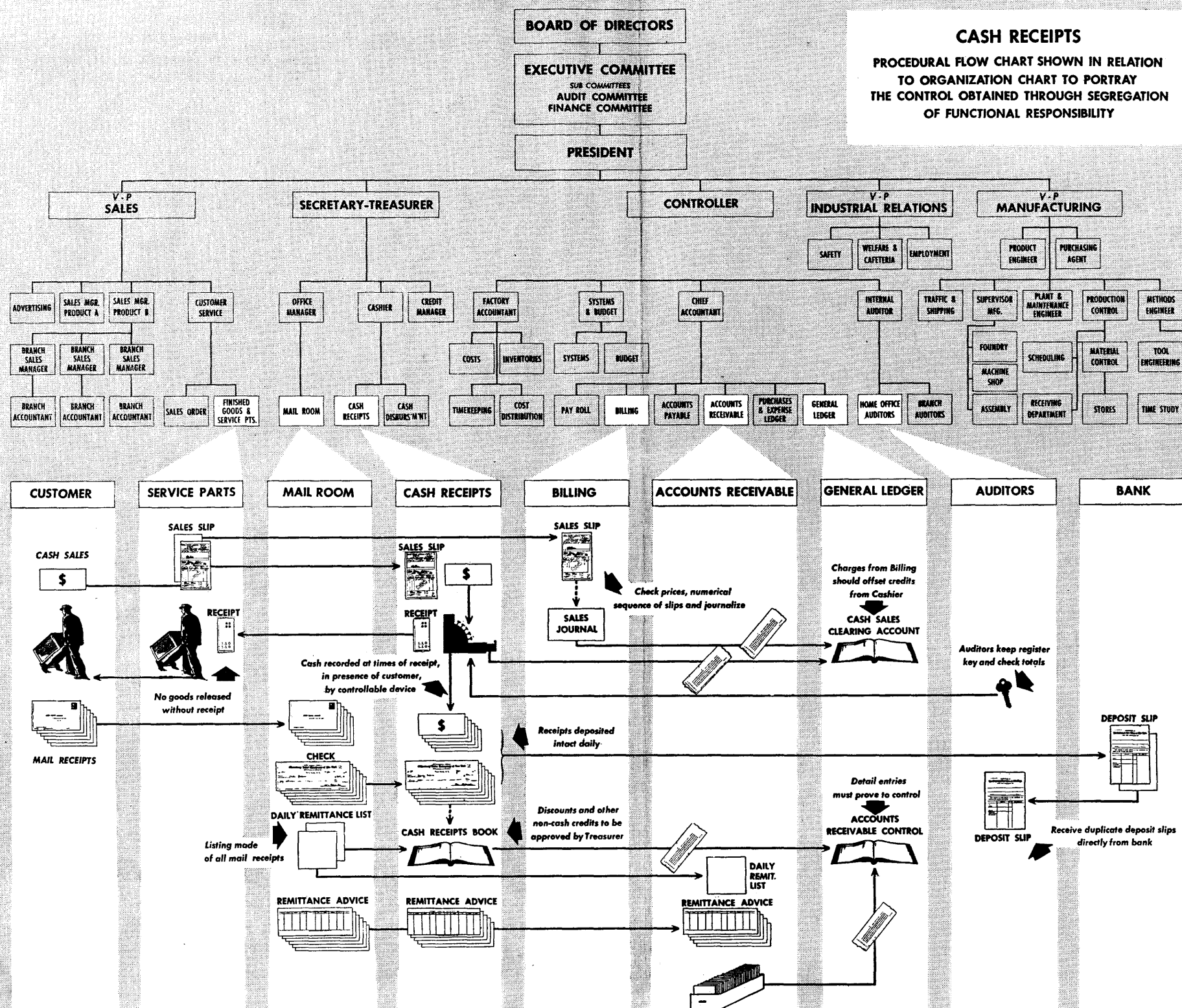
PROCEDURAL FLOW CHART SHOWN IN RELATION
TO ORGANIZATION CHART TO PORTRAY
THE CONTROL OBTAINED THROUGH SEGREGATION
OF FUNCTIONAL RESPONSIBILITY

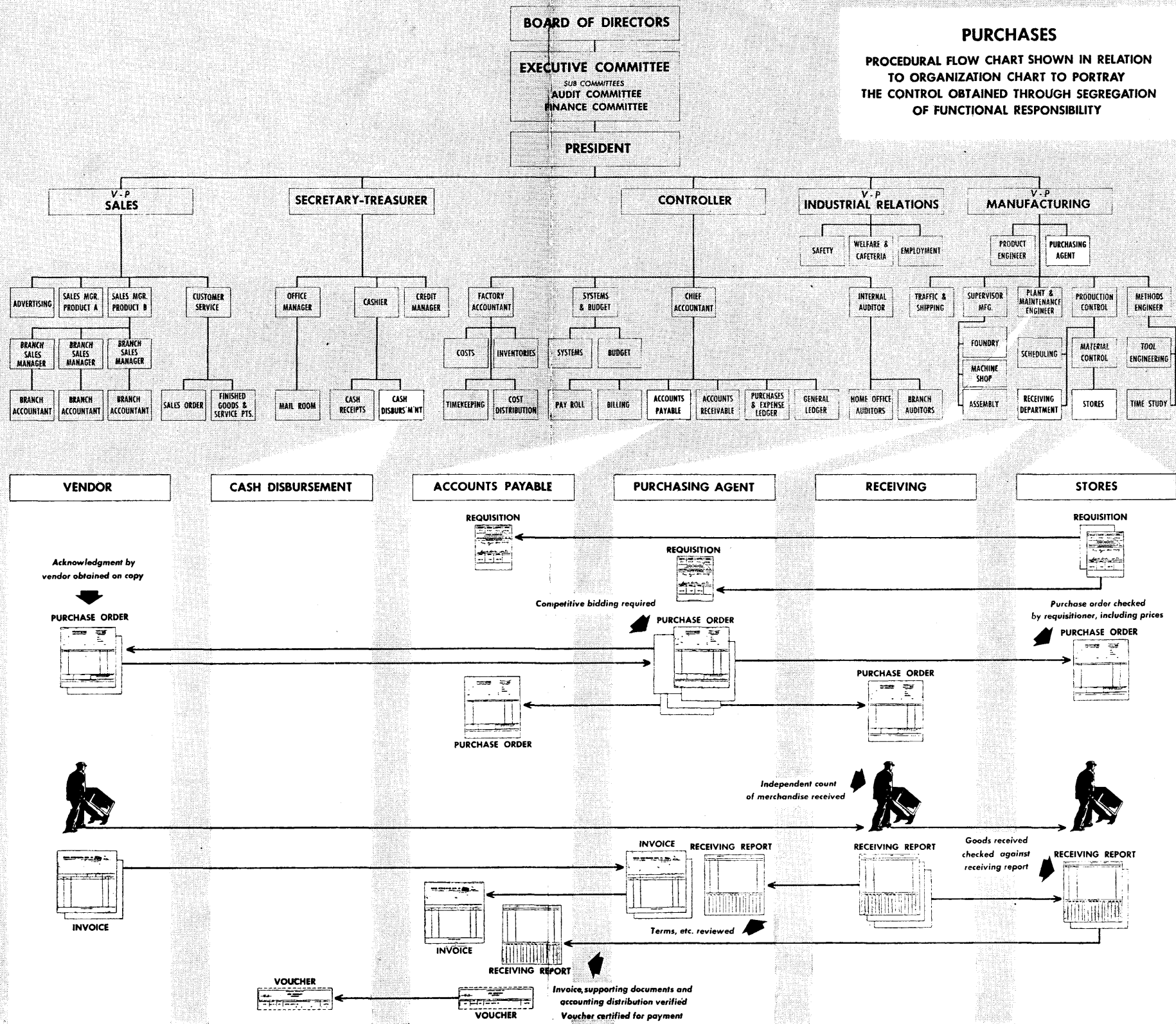




CASH RECEIPTS

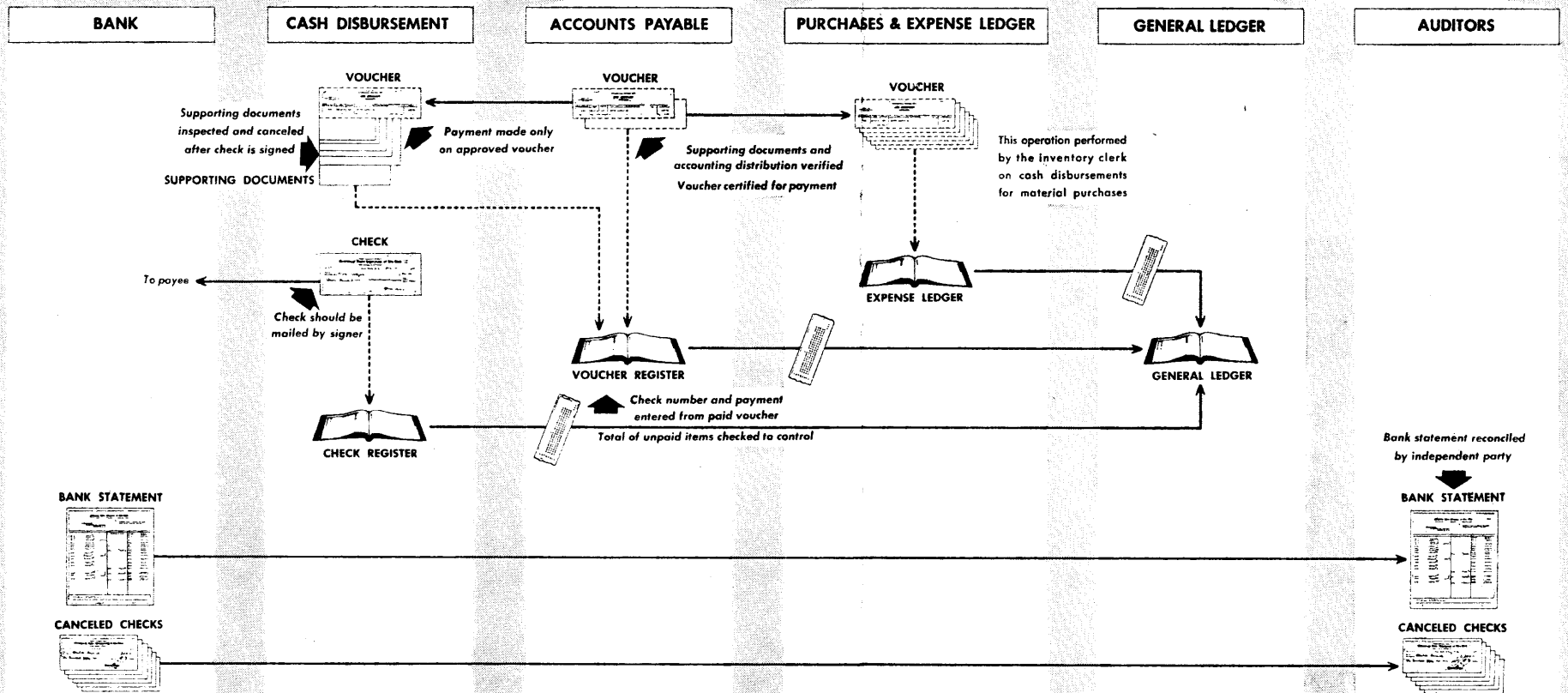
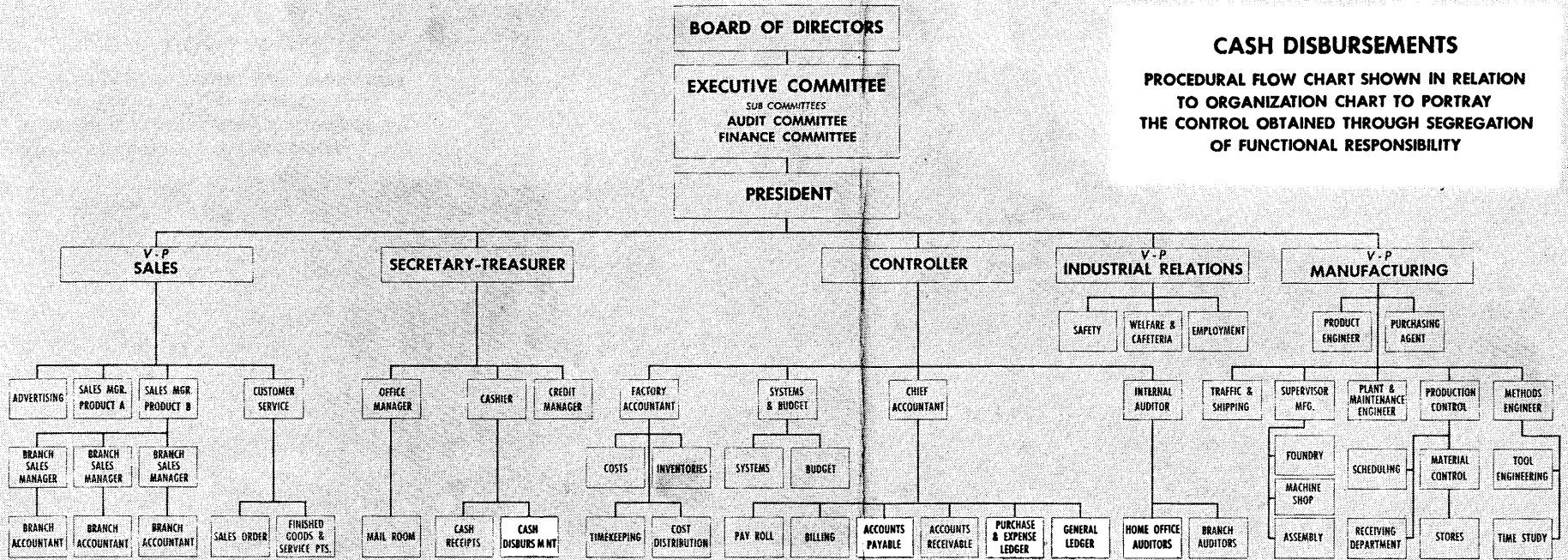
PROCEDURAL FLOW CHART SHOWN IN RELATION
TO ORGANIZATION CHART TO PORTRAY
THE CONTROL OBTAINED THROUGH SEGREGATION
OF FUNCTIONAL RESPONSIBILITY





CASH DISBURSEMENTS

PROCEDURAL FLOW CHART SHOWN IN RELATION
TO ORGANIZATION CHART TO PORTRAY
THE CONTROL OBTAINED THROUGH SEGREGATION
OF FUNCTIONAL RESPONSIBILITY



BOARD OF DIRECTORS
EXECUTIVE COMMITTEE
SUB COMMITTEES
 AUDIT COMMITTEE
 FINANCE COMMITTEE
PRESIDENT

PAY ROLL
 PROCEDURAL FLOW CHART SHOWN IN RELATION
 TO ORGANIZATION CHART TO PORTRAY
 THE CONTROL OBTAINED THROUGH SEGREGATION
 OF FUNCTIONAL RESPONSIBILITY

